

# STRENGTHENING REGIONAL AND LOCAL ECONOMY

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# **STRENGTHENING REGIONAL AND LOCAL ECONOMY**

**IRSA Book Series on Regional Development No.17**

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## FOREWORD

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First, I would like to congratulate the publication of “Strengthening Regional and Local Economy”, the 2019 IRSA Book Series of Regional Development. The content of this book was selected from the best presentations at the 14<sup>th</sup> IRSA International Conference held in Solo, hosted by Universitas Sebelas Maret in 2018. IRSA is indebted to all the authors of each of the chapter and in particular to the editors who have worked tirelessly to maintain the quality of the book series. IRSA Book Series of Regional Development, in addition to IRSA Annual Conference, is the flagship of IRSA activities and the key to IRSA’s reputation in the academic and policy arena in Indonesia and the Asia Pacific region.

The topic of this book is also a special one, particularly for IRSA and regional scientists in Indonesia in general. Although Indonesia has been decentralizing many of its development authority to regions and localities, national issues or development agendas that have nation-wide attention are still more appealing as topics of analysis to academics and development practitioners. This may have made the real development actions at the local and regional level get less attention than it deserves. Indonesia’s geography, demography and socio, economic and political aspects are so spatially-heterogenous that require specific analysis that are so distinct from place to place.

This book, therefore, serves as a reminder to all of us that selecting development priorities should not be done in Jakarta, but should start at the local level. One of the challenges to this is the regional imbalance of intellectual activities. Many best academic institutions including its intellectuals are still centered around Jakarta or a few regions in Java. Yet, development challenges are mostly local and regional. IRSA has definitely a responsibility to close this imbalance through various

activities of academic capacity building in the regions. Publication of this book is one of IRSA's attempts to meet these challenges.  
Congratulation.

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*Prof. Arief Anshory Yusuf*

President of Indonesian Regional Science Association

May 2019



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# **CHAPTER ONE**

## **LOCAL ECONOMY AND REGIONAL DEVELOPMENT IN INDONESIA: A NOTE**

**Tri Mulyaningsih, Bhimo Rizky Samudro, Vincent Hadi Wiyono, Devanto Pratomo, Hefrizal Handra, Arief A. Yusuf and Budy P. Resosudarmo**

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### **INTRODUCTION**

Indonesia is the world's largest island country with more than seventeen thousand islands. As the region is geographically diverse, the development strategy should consider the internal characteristics of the regions. By the end of 1990s, Indonesia introduced the decentralisation policies through Laws No. 22/1999 and No. 25/1999 that transferred both political authorities and financial resources to local government. The aims of the policy are to spur the development at the regional level and provide better public service delivery to locals by bringing government closer to the community. Under the Laws No. 22/1999 and No. 32/2004, the districts and municipalities have the authority to enact policy in broad areas of health, education, public works, environment, economy related to communication, transport, agriculture, manufacturing industry and trade, capital investment, land, cooperatives, labour force, and infrastructure (Resosudarmo et al. 2002; Hill et al. 2008; Nasution 2016).

Due to decentralisation, given substantial authority to govern the region, the local governments should be able to improve the public service deliveries. As they are closer to the locals, they have the authority to design the policy according to the local characteristics.



Decentralization is also expected to facilitate internal factors to produce local initiatives that could be the source of local growth. Decentralisation is also expected to facilitate the local people to create knowledge and technology that may lead to new products and new policies from the initiatives of social agents, civil society, industry and government. This approach is known as “bottom-up” which underlines the importance of endogenous forces to create development strategy based on local characteristics (Todtling 2011).

So far, however, it is argued that many local governments experience challenges in governing their regions and in improving local standard of living. Some studies suggest that with more authorities to govern, the local government does not necessarily boost the performance of local and regional economy (Alisjahbana and Brodjonegoro 2004; Fitriani, Hofman and Kaiser 2005; Pepinsky and Wihardja 2011 and Lewis 2017). Another issue is that, after the enactment of the decentralisation policy, the number of local government units increased substantially by half (Fitriani, Hofman and Kaiser 2010). In the beginning of 2000 the administrative units of government in Indonesia consisted of 26 provinces, 268 districts, 73 municipalities, 4,049 subdistricts, and 69,050 villages. By 2013 the number of government administrative units increased in which there were 34 provinces, 415 districts, 98 municipalities, 9,982 subdistricts, and 80,414 villages (Fitriani, Hofman and Kaiser 2010; Nasution 2016). The majority of local government proliferation took place outside Java islands where human capital and capacity are low. An increase of administrative unit turns out to limit the local governments to exploit economies of scale. Overall, it is observed that decentralisation has not significantly linked to better economic outcome measured by gross domestic product. The three factors undermining the development as most commonly mentioned in the literature are: (1) significant heterogeneity in endowments; (2) immobility; and, (3) endogenous deterioration of local institutions including corruptive behaviour in the local government administration.

The above discussion serves as an introduction to the following ten chapters on strengthening regional and local economy in Indonesia. This book is particularly organized into four-parts mainly discussing the decentralisation, local innovation and local economy. The first part consisted of two chapters focussing on the local government innovation,

including the innovation in health services delivery in Nusa Tenggara Timur (NTT) and local business development in Aceh. The second part presents three papers on local business and economy issues of financial inclusiveness of local business in West Sumatera, strengthening dairy production in Pasuruan regency of East Java and efficiency of food and beverages industry. The third part concerns about the rural development and peripheral economy particularly on rice cultivation technique and *Dusung* farming in two provinces in the east part of Indonesia of Papua and Maluku. Finally, the fourth part consists of three papers discussing interregional capital allocation with spillover effects, the decentralisation and public service delivery using the political economy perspective and the sustainability of fishery industry in Indonesia by comparing the fisherman term of trade (FTT) before and after the fighting against illegal fishing policy.

## CONTENT OF THIS BOOK

### Part I. Local Government Innovation

During decentralisation, some regions produced some initiatives to improve the public service delivery and encourage the establishment of local business. The local initiatives are developed by considering the local characteristics, local problems and resources of the regions (Giguere and Considine 2008). Local innovations are generally driven by partnership between local government and other stakeholders in the regions. Partnership among governments and the local community is essential to create effective policies and programs. According to Pike, Rodriquez-Pose and Tomaney (2011), partnership involving the representatives of public, private, civil society and local government is able to take into account the various dimensions of the problems and produce optimal solutions for those problems.

The first part of the book, concerning about local innovation introduced by some regions in Indonesia, consists of two papers awarded by research support grants provided by the Indonesian Regional Science Association (IRSA) with collaboration of the Local Government Innovation. The two papers were successfully selected among 70 proposals submitted to the committee to win the highly competitive research support grant. The successful recipients of the grants are Maria



Silalahi (NTT Health Office) and Salut Muhidin (Macquarie University) for their research entitled “Innovative Program of the 2H2 Health Referral System in Flores Timur District, NTT Province to Improve Maternal and Newborn Health (Chapter 2) and Saiful Mahdi (Unsyiah), Dian Rubianty (UIN Ar-Raniry) and Laja Yusnadi (Unsyiah) for their research entitled “Enterprising *Gampong*: the Roles of BPKG and Village Fund in Developing BUMDES in South Aceh, Indonesia” (Chapter 3).

Chapter 2 written by Salut Muhidin, Maria Silalahi, Rachmalina Prasodjo and Jerico Pardosi discussed the innovative health program in Nusa Tenggara Timur Province aimed to improve maternal and newborn health. The objective of this study is to document the dynamic implementation of an innovative health program in Nusa Tenggara Timur (NTT) called “the 2H2 referral system” (i.e., “*2 hari sebelum dan 2 hari sesudah persalinan*” or 2 days before and 2 days after the delivery). This intensive health monitoring program aims to save mothers and their children during delivery time through adequate birth health facilities. Since the 2H2 system was introduced in 2010, there have been some improvements in health indicators with a special focus on maternal mortality rates and health facility births. Yet, the figures vary from one district to another in which the district of Flores Timur has been the top achiever. This study is expected to contribute to better understanding on the issues of health equality and equity in Indonesia, particularly how to improve maternal and child health in NTT. Consequently, it could provide practical contribution for any local governments where the characteristics of health development are similar to those in this study.

The second paper, Chapter 3, entitled “Enterprising *Gampong*: The Role of BKPG and Village Fund in Developing BUMDES in South Aceh, Indonesia”, was prepared by Saiful Mahdi, Dian Rubianty, and Alja Yusnadi. This study aims to identify the relation between Aceh’s village financial assistance program (*Bantuan Keuangan Peumakmu Gampong/BKPG*), Indonesia’s national program of Village Fund (*Dana Desa/DD*), and the creation of village enterprise (*Badan Usaha Milik Desa/BUMDES*). It is also aimed at identifying innovation in the process and looking at the possibility of how the programs would make a village “enterprising”. The research used both qualitative and quantitative data from interviews, FGD, and perception questionnaire survey of 260 village heads in South Aceh. Descriptive statistics was used to find common trends and pattern



and correlation analysis was incorporated. The findings show that BKPG precedes and its evaluation contributes to the shaping of village fund. It also helps trigger the creation of many village enterprises in Aceh. Village enterprises in South Aceh faced serious sustainability problem until 2016. The correlation between cognitive understanding of the fund and attitude of village heads exists, but capacity and integrity to develop and sustain village enterprises remain weak. District Government of South Aceh tackles sustainability issues by innovating in district budgeting in 2017, but to succeed as enterprising villages would need better human capacity. Given a unique context of post-conflict and post-disaster in Aceh, a diligent observation of cultural and social capital is needed on top of human and financial capital.

## **Part II. Local Business And Economy**

The next three papers (Chapters 4-6) focus on the development of local business. The first two papers discuss the development of micro and small business particularly in terms of access to financial services and human capital. The data published by the Bureau of Statistics (BPS) show the number of Indonesian business units dominated by the micro and small business that is more than 26 million across provinces in Indonesia. The proportion of micro and small business in Indonesia by 2017 was more than 98% of total business units. In addition, the micro and small businesses have substantial role in absorbing labour of more than 59 million or approximately 75.33% of total workers in Indonesia. This business has proven to be resilient than the larger business as shown by the ability of the micro and small business to survive during the economic crisis of 1997-1998. Nevertheless, the micro and small business suffer with many limitations, for example lack of access to loans from financial institutions, lack of human capital as both the owner and the workers have low education. Besides, the business process is very simple and mostly employs very simple technology and therefore it is unable to adjust with the changes in consumers' preferences (BPS 2018).

Part II also concerns with the performance of medium and large industries by measuring the efficiency level of food and beverages industries in Indonesia in the past 30 years. Efficient industry is capable to produce with the least cost structure or the industry can produce the largest output level by using a certain level of input. The literature

suggests that efficiency is contributed by the exploitation of scale of economy in the production process and the competition in the industry. Furthermore, the higher efficiency level may lower the price of the product. Meanwhile, if the industry is less competitive the improvement of efficiency may not transmit into lower price because the firms have substantial market power.

Chapter 4 entitled “Cultural Creative Industries Model for Financial Inclusiveness: Evidence from Small and Medium Enterprises in West Sumatra” written by Widya Fitriana, Ernan Rustiadi, Akhmad Fauzi, and Lukytawati Anggraeni. While creative economic development in Indonesia is still concentrated in Java Island as a developed region with the highest investment competitiveness, other areas outside Java could potentially develop creative economics in order to reduce economic inequality between regions. This paper reveals that entrepreneur, firm and regional characteristics affect financial inclusion relating to bank access. However, relating to credit usage, it is only influenced by entrepreneur and firm characteristics. Using 1.367 samples of creative industry in West Sumatera, this study proves that there are 57.4% small creative industries located in low growth and low income region with a limited infrastructure, and firm size becomes the strongest factor affecting financial inclusion relating to bank loan. Therefore, financial education, woman targeted credit program, and strengthening infrastructure especially in low growth and low income region play a crucial role in promoting financial inclusion of creative industry in West Sumatra.

Chapter 5 entitled “Activating Local Economy through Dairy Production: A Case of Pasuruan Regency” by Eko Budi Santoso, Felicia Esterlita Nugroho, and Vely Kukinul Siswanto, explains about the number of poor households that is still high, at 10.57% in the Pasuruan regency which has potential natural resources in dairy farming. In their study, the authors used the method to find the local economic activation strategy for dairy farming, i.e., Root Cause Analysis (RCA) in order to know the problem of development. Second, supply-chain analysis is employed to find the value chain of dairy production. To determine the local activation strategy, they use the hexagon of Local Economic Development (LED). There are three findings from the analysis. First, the need to empower the community through improving the human resources quality. Second, the integration among breeders, government, and private sector that actively



contributes to improving the quality and quantity in the dairy products to enhance the competitiveness in the market. The policy implications that need to be implemented are seizing business opportunities in the local community through stakeholders' integration, supporting community entrepreneurial initiatives, and facilitating market access.

In Chapter 6 entitled "Persistence of Price-Cost Margin and Technical Efficiency in the Indonesian Food and Beverages Industry" Maman Setiawan investigates the persistence of price-cost margin and technical efficiency of the firms and their relationship in the Indonesian food and beverages industry. This study uses panel data of 44 subsectors in the Indonesian food and beverages industry for the period 1980-2014. Data envelopment analysis with bootstrapping approach is applied to estimate technical efficiency score. The autoregressive model accounting for the endogeneity problem is used to estimate persistence coefficients of price-cost margin and technical efficiency. A cross-sectional regression model is also applied to estimate the relation between the persistence of price-cost margin and the persistence of technical efficiency. The results show that there is a quite high persistence of price-cost margin and technical efficiency of the firms in the industry. Furthermore, the persistence of price-cost margin affects the persistence of technical efficiency negatively in the industry.

### **Part III. Rural Development and Peripheral Economy**

This part discusses the topic related to rural development and the peripheral economy. In the rural areas, agriculture sector has significant role in providing jobs and producing goods. The Bureau of Statistics reports that by 2017 approximately 30% of jobs, which are close to 36 million in number is provided by the agricultural sector. Moreover, the contribution of agricultural sector in providing jobs exceeds other sector, such as trade (28 million), services (20 millions) and manufacturing (17 millions). Despite its contribution in providing jobs, the agricultural sector contribution in the national income declines and it was only 14% by 2014. The data of growth of national income across sector is also confirmed that the agricultural sector did not perform well compared to other sectors. By 2014, the growth of agricultural sector was 3.29% and this was below the growth of overall economy by 5.06% (with gas). This sector has low productivity because most of farmers are smallholders



owned a small fraction of land. The figure of productivity measured by the production for each hectare shows that the productivity is stagnant in 13 years. Moreover, the productivity level was lowered by 0.7% in 2011 and 2.9% in 2018. This part provides discussion on the nature of agricultural process in Papua and Maluku that is influenced by characteristics of the culture in the region.

The two chapters (Chapters 7-8) in Part III discuss farming method in Papua and Maluku. The first chapter entitled "Rice Cultivation of Indigenous People in Merauke Regency, Papua" by Julius Ary Mollet and Budy P. Resosudarmo describes the rice cultivation technique adopted by the indigenous people of Marind in Merauke regency, Papua. This technique has been argued to be suitable for the region and productive in producing rice. A household survey was conducted between 2014 till 2016 visiting 168 farm households randomly chosen in the regency. The authors found that that majority of lands distributed among the indigenous farmers were small and that indigenous farmers mostly use rainfed as their source for irrigation. Urea is used as fertilizer by the majority of indigenous farmers. Ir, pandan wangi and mambramo are the varieties of rice used in paddy planting. In general, rice cultivation is found to be profitable for the indigenous farmer.

The second paper (Chapter 8) is focused on an indigenous agro-forestry systems called *Dusung* which has been practiced by farmers in Ambon Islands for a long time. The systems played a crucial role to sustain the natural and human resources in the small islands. In the chapter entitled "The Contribution of Sustainable *Dusung* Farming to Household Income in Small Islands: A Case in Ambon Island, Indonesia" written by Wardis Girsang, Marthin Gideon Nanere, Adelina Siregar, and Hamid, it is stated that because of limited natural resources, small islands are also sensitive to social conflict and environmental degradation. However, little is known about agro-economic contribution of the *Dusung* farming systems to household income. The purpose of this article was to explore the agro-economic of *Dusung* farming systems, including *Dusung* formation process, characteristics of *Dusung*'s farmers, the structure of agronomy crops and economic contribution of the edible fruits and spices crops to household income.

This research was conducted in three different *Dusun* areas in Ambon city island, including Negeri Hutumuri, Negeri Hative Besar and Negeri Soya. Based on agronomic-economic view, findings suggest that there were at least around 26 kinds of plantation and edible crops in the *Dusun*. Annual average household income was IDR 84.3 million and more than 80% was obtained from the main crops, especially clove, durians, nutmeg, snake fruit and mangosteen, even though it was followed by income inequality. The findings also show that the size of land and farmer age influenced household income. This implies that large size of land and young farmers influenced the real household income. The authors suggest (1) to develop *Dusun* land protected area from the forest-land scape to coral reef-sea scape, and (2) to develop *Dusun* modernization through incorporating science and technology to manage land use and improve productivity of primary crops as part of *Dusun* Agro-tourism Development (DAD).

#### **Part IV. Decentralisation, Development and Sustainability**

The transfer of political authority was followed by the transfer of financial resource from the central government to the local government. The Law No. 25/1999 is the basis of the financial decentralisation in which local governments receive transfer from the Central Government in the form of block grant or *Dana Alokasi Umum* (DAU), Specific Grant or *Dana Alokasi Khusus* (DAK), revenue shared fund or Dana Bagi Hasil/DBH (generated by taxes/DBH Pajak and mineral resources/DBH Sumber Daya Alam). Furthermore, starting from 2014 central government has disbursed direct transfer to village, known as village funds (*Dana Desa*). The values of village funds increased across years from IDR 1.4 trillion in 2014 to almost IDR 2.3 trillion in 2017 (Ministry of Finance 2017).

Part IV discusses financial decentralisation policy intended to lower the regional disparity, stimulate development in the regions and encourage the bottom-up process in planning and implementing the development process. It focuses on the financial decentralisation in Indonesia particularly the interregional public investment and village funds. The public investment is essential to support the development in the regional areas as mentioned by Mitshuhiko Kataoka (Chapter 9). According to Kataoka, the investment allocation after 1998 has been

more dispersed. Prior 1998, the public investment was more concentrated in Java-Bali regions and by 1998 the concentration was lower. The following chapter also discusses the allocation of village funds in Indonesia and concludes that the political connection influences the allocation of the transfer funds to village. It also concerns about the sustainability of development by discussing the impact of fighting into illegal fishing to the sustainability of fishery sector in Indonesia.

Kataoka's paper entitled "Interregional Allocation of Capital with Spillover Effects in Indonesia's Pre- and Post-Crisis Economy" has focused on efficiency-equity trade-offs in order to explain public investment allocation across subnational regions. Other studies have even incorporated political economy factors as determinants. However, all works on this topic have ignored its interregional spillover effects. To bridge this gap in the literature, this study applies Kataoka's (2013b) equity-growth allocation share of public investment, incorporating its spillover effects, in order to examine the interregional allocation of public capital in 1986-2007 in Indonesia. It also identifies the extent to which the interregional spillover effects of capital influence province-level interregional allocation. The study shows that investment concentration in the Java-Bali region for 1987-1997 dispersed from 1998, although this trend does not indicate a pro-efficiency investment allocation policy. Moreover, the province of Jakarta shows relatively large positive difference values, while the remaining provinces located in Java show negative difference values.

Chapter 10 discusses democracy, effective leadership and public services delivery written by Ni Made Sukartini, Achmad Solihin, Albertus Girik Allo, and Ni Nyoman Alit Triani. This study evaluates whether villages that are politically connected with the elected government received higher transfer fund from the higher level government. Analysis is based on *Potensi Desa* (Podes) data in 2005, 2011 and 2014. Applying Ordinary Least Square (OLS) and linier regression with instrumental variable, i.e., availability and quality of TV and telephone connection, the study shows that first, villages that were politically connected with the result of the 2004 General Election significantly received larger transferred fund from the higher level of government. Second, there were stronger evidences of connection between villages and districts level, but less evidences were observed



between villages at the provincial and national level. Third, leader's characteristics, such as education level and age do not matter in terms of public services delivery. This implies the democratic process should boost effectiveness in leadership, and this should be prioritized at the village level of Indonesia to enriched fiscal decentralisation.

The final chapter, Chapter 11, discusses the Indonesian fisherman exchange rate before and after the fighting against illegal fishing written by Siwi Nugraheni, Artauli Pebrianti Sitanggang, and Gregorio Laurensius Lala. Since the end of 2014, the Ministry of Maritime Affair and Fisheries (MOMAF) of the Republic of Indonesia has intensively battled illegal fishing. The policy was expected to overcome overfishing, as well as to increase the welfare of Indonesian fishermen. The MOMAF claims that the policy has increased the Indonesian Fisherman Term of Trade (FTT). This research aims to compare the average Indonesian FTT, before and after the policy, both at national and provincial levels, using FTT monthly data (from January 2014 to December 2017), and two timeline scenarios of 'before' and 'after'. The first scenario uses the timeline of January 2014 up to April 2015 as the 'before', and of may 2015 up to December 2017 as the 'after'; while the second scenario uses the timeline of January 2014 up to July 2015 as the 'before', and of August 2015 up to December 2017 as the 'after'. This study concludes that at national level, for both scenarios, the average Indonesian FTT of 'after' the policy is significantly higher than that of 'before' the policy. At the provincial level, however, not all Indonesian provinces experience an increase in their FTT. In both scenarios, the provinces experiencing a decrease in FTT are North Sulawesi, Maluku, and Papua. Additionally, not all increases in FTT at the provincial level are considered statistically significant.

## **FINAL REMARKS**

The purpose of this book is to update discourses on the regional and local development particularly after the introduction of decentralisation policy in the late 1990s. As have been discussed previously, the policy facilitates local governments to manage their economy autonomously regarding to the local potency and to design the policy to solve the problem by utilising the local resources that lead to the improvement of public service delivery. Regional and local governments have innovations

in designing policy related to public service delivery in health in NTT and boosting the local economy in the village using deconcentration transfer funds. Nevertheless, the challenges for developing the local economy remained significant due to lack of capacity, funding, and human resources.

This book presents evidences that micro and small business experience limited access to financial loans in West Sumatera, low productivity in the dairy industry in Pasuruan, and uncompetitive market structure in the food and beverage industry nationwide. Regarding to rural economy, the book discusses the farming methods practiced in two provinces in eastern part of Indonesia, i.e., Maluku and Papua, that were influenced by both the local tradition and practice and technology from other regions and ethnicity. Specifically, this book also discusses the impact of financial decentralisation on public investment and regional disparity. In addition, financial decentralisation of village funds is being scrutinised by relating the allocation of the transfer to the political connection. The last chapter of the book aims to assess the government policy in fighting illegal fishing and found that this contributes to higher welfare of fishermen and sustainability of the fishery sector.

This book also offers some policy recommendations to drive the local and regional economy and improve the decentralisation policy to enable local governments deliver the public services better. The government partnership that encourages the community engagement with government program is essential to improve the quality of health service delivery. This book also underlines the importance of capacity building, in addition to financial transfer, for local governments, community and business to promote the creation of local business and have sustainable business. It is also important to have partnership involving businesses in the upstream and downstream of the industry to improve the product competitiveness.

The Government may take a further step to provide financial education and financial supports through loans for local business. The Government should also be actively involved in removing all barriers to enter the market in order to improve the competitive environment. As the market is becoming more competitive, the efficiency will in turn increase and the price level gets lowered. With regard to the improvement of

agriculture productivity, the Government is advised to provide more officer to actively educate the indigenous farmers to adopt better farming technique, apply irrigation and technology to lower the production cost, and encourage the establishment of integrated *Dusun* land protected area to conserve natural resources. Concerning the financial decentralisation, it is important to consider about interregional capital allocation with spillover effects in understanding the role of financial decentralisation in lowering regional disparity. In sum, the policy may be directed to enhance the capacity of the leader in order to improve the region's capability to generate local revenues.

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